Nos. 21824 and 21824-A

In the United States Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA, APPELLANT

v.

JOE R. RAMOS AND MARY RAMOS, APPELLEES

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v.

UNITED STATES OF AMERICA, APPELLEE

On Appeals from the Judgment of the United States District Court for the Northern District of California

BRIEF FOR THE UNITED STATES AS APPELLEE AND REPLY BRIEF FOR THE UNITED STATES AS APPELLANT

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QUESTIONS PRESENTED BY TAXPAYERS' APPEAL [1]

1. Whether, assuming that there was a valid family partnership during the year 1956, the District

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[1] Since the opinion below and the jurisdictional statement have been set out in our brief as appellant, they will not be repeated here.

Court erred in holding that the sum of $70,640.48 received in the year 1956 for crops sold during the calendar year 1955 was taxable to taxpayers and not to the members of the alleged 1956 partnership.

2. Whether, assuming that a valid family partnership existed during the year 1956, the District Court erred in allocating 25 percent of the partnership's crop receipts for 1956 to taxpayers for the use by the partnership of the land, trees and equipment which made up the Ramos Home Ranch and which were owned by taxpayers.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations involved are contained in Appendix A to the opening brief for the Government.

STATEMENT

The findings and conclusions of the District Court concerning the taxpayers' appeal (I-R. 67-68) may be summarized as follows:

In 1956, the Ramos family partnership reported as part of its gross income the sum of $70,640.48 received for almonds which were raised on taxpayers' ranch and were sold in 1955, before the partnership was to become operative. The United States contended below that the $70,640.48 received in 1956 was earned by and taxable only to taxpayers. The District Court, holding for the Government on this point, stated that the $70,640.48, though received in 1956 by the partnership, "represented income earned ex-

clusively by the plaintiffs [taxpayers] and generated by their services and by property owned and controlled by them." (I-R. 68.) The court reasoned that taxpayers, having earned the $70,640.48 for the crops sold in 1955, could not defeat or avoid their tax liability by assigning the account receivable to the 1956 partnership. (I-R. 68.) From this holding, taxpayers appealed.[2] (I-R. 91.)

The 1956 partnership had the use of taxpayers' land, trees and equipment in the production and harvesting of the crops during that year and paid no rent therefor. (II-R. 20-21, 155-156, 483, 487-488.) The Government argued below that if a valid partnership was found to have existed during the year 1956, then, the land, trees and equipment should be considered as having been contributed by taxpayers to the capital of the partnership and would thereby be a determining factor in allocating the distributive shares of the partnership income among the partners in relation to the contribution of capital and services which each made to the partnership. The District Court rejected the contention of the Government that the land, trees and equipment were to be treated as if contributed to the capital of the partnership, but did, however, hold that the income of the 1956 part-

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[2] Likewise, the District Court held that income in the amount of $157,088.71 reported by the 1957 partnership as part of its gross income and which was received in 1957 for almonds and peaches raised, sold and delivered to the buyer by the 1956 partnership was income earned by and taxable to the members of the 1956 partnership and not to the members of the 1957 partnership. (I-R. 68.) Taxpayers did not appeal from this holding.

nership had to be corrected by allocating to taxpayers a reasonable rental value for the use by the partnership of the land, trees and equipment. (I-R. 52.) The District Court found that the reasonable rental value for the land, trees and equipment, as expressed in an agreement between the 1957 partnership and taxpayers, was twenty-five percent of the crop income. (I-R. 69.) Accordingly, the court found that the reasonable rental value for 1956 was $37,500. (I-R. 73.) From this finding, both the Government and taxpayers appealed (I-R. 88-89, 91-92), the Government urging that the land, trees and equipment should have been considered to have been contributed to the capital of the partnership and taxpayers claiming that no rent whatsoever should have been charged to the partnership for its use of the land, trees and equipment in 1956.

SUMMARY OF ARGUMENT

1. Taxpayers argue that the sum of $70,640.48 received in 1956 for almonds which were raised on taxpayers' ranch and were sold in 1955 is taxable to the members of the alleged 1956 partnership. The sum in question, however, represented income earned exclusively by taxpayers and was generated by their services and by property owned and controlled by them. And, it is at this time axiomatic that the basic concept of income taxation—that the income from service rendered is taxable to the person who renders the service and that income from property is taxed to the person who owns or controls the property—can-

not be defeated by a transfer or assignment to another. *Helvering* v. *Horst*, 311 U.S. 112; *Lucas* v. *Earl*, 281 U.S. 111; *Helvering* v. *Eubank*, 311 U.S. 122.

2. Taxpayers, in addition, argue that no part of the 1956 partnership income should be allocated to them for the use by the partnership of the land, trees and equipment comprising the Ramos Home Ranch. The Government, on the other hand, contends that these assets should be treated as if they had been contributed to the partnership by the taxpayers. To so treat the assets is supported by the fact that the economic effect of allowing the partnership the use of the assets without requiring any compensation therefor is the same as if they had been contributed to the partnership. And, as Section 704(e)(2) of the 1954 Code provides that the distributive share of a member of a family partnership whose interest was acquired by gift or purchase from another family member shall be determined by the partnership agreement "except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital", a reallocation of the income of the 1956 partnership should be made so as to properly credit taxpayers with the income earned through the use of land, trees and equipment contributed by them to the partnership.

ARGUMENT

I

The District Court Correctly Held That the Sum of $70,640.48 Received In the Year 1956 Was Taxable to Taxpayers and Not to the Members of the Alleged Partnership

The question presented by taxpayers' argument that the 1956 partnership (and not they themselves) is accountable for the $70,640.48 received in 1956 is whether one who is presently entitled to receive income and who is taxable only on receipt of payment can escape taxation by giving away his right thereto in advance of actual payment. As recognized by the District Court (I-R. 68), it is at this time axiomatic that the basic concept of income taxation—that the income from service is taxable to the person who renders the service and that income from property is taxed to the person who owns or controls the property—cannot be defeated by a transfer or assignment to another before the income is realized. *Helvering* v. *Horst*, 311 U.S. 112; *Lucas* v. *Earl*, 281 U.S. 111; *Helvering* v. *Eubank*, 311 U.S. 122.

The doctrine of anticipatory assignment of income is frequently stated in terms of the metaphor of Mr. Justice Holmes in *Lucas* v. *Earl*, *supra* (p. 115) that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." This is more than a graphic figure of speech; rather it is a statement of the doctrine that earned income is to be taxed to the one who earns it. See 2

Mertens, Law of Federal Income Taxation, 1961 rev., Sec. 18.02. Thus, in *Lucas* v. *Earl*, *supra*, an attorney remained taxable on salaries and fees earned by him in spite of a prior, binding agreement whereby those salaries and fees were owned in joint tenancy with his wife; in *Helvering* v. *Horst*, *supra*, a father who owned a coupon bond was taxable on interest received by his son even though he had detached the interest coupons and had given them to the son before they matured; and in *Helvering* v. *Eubank*, *supra*, the taxpayer, a former insurance agent who had validly assigned to a third party his right to certain renewal commissions which were to be paid without the rendition of any further service, was held taxable on the renewal commissions in subsequent years when they were received by the assignee.

This Court has held likewise. In *Commissioner* v. *Fender Sales, Inc.*, 338 F. 2d 924, certiorari denied, 382 U.S. 813, the Court stated (p. 929):

> But, in Horst, the Supreme Court relied on the broader concept of "realization of income" rather than a restricted notion of actual payment for its conclusions, and we think it necessary and logical, in the just administration of the tax laws, that the Courts continue to recognize that a taxpayer may realize the income represented by an account receivable by exercising his rights of control and disposition of it for his economic benefit in ways other than receipt of payment in money. In Commissioner of Internal Revenue v. Lester, 1961, 366 U.S. 299, 304, 81 S. Ct. 1343, 1346, 6 L. Ed. 2d 306, the Supreme Court approvingly quoted from Horst: "The power to dis-

> pose of income is the equivalent of ownership of it." We add, the exercise of the power to dispose of income is the equivalent of the realization of it.

And in *United States* v. *Snow*, 223 F. 2d 103, certiorari denied, 350 U.S. 831, this Court had earlier stated (pp. 109-110):

> It has been the rule since *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731, that income tax cannot be escaped by a taxpayer's assigning to another *the right to receive ordinary income.* (Emphasis in original)

See also *Idaho First National Bank* v. *United States*, 265 F. 2d 6 (C.A. 9th); *Family Record Plan, Inc.* v. *Commissioner*, 309 F. 2d 208 (C.A. 9th), certiorari denied, 373 U.S. 910; *Daugherty* v. *Commissioner*, 63 F. 2d 77 (C.A. 9th); *Strauss* v. *Commissioner*, 168 F. 2d 441 (C.A. 2d), certiorari denied, 335 U.S. 858; *Floyd* v. *Scofield*, 193 F. 2d 594 (C.A. 5th); *Turnbull, Inc.* v. *Commissioner*, 373 F. 2d 91 (C.A. 5th); *Duran* v. *Commissioner*, 123 F. 2d 324 (C.A. 10th); *Williamson* v. *United States*, 292 F. 2d 524 (Ct. Cl.).

Taxpayers' argument (Br. 44-45) that the account receivable represented "a business asset which was utilized in the conduct of the partnership business" and should therefore not be taxable to taxpayers, is without merit. Whether the account receivable is or is not an asset of the "crops business" is not here in question—nor does the resolution of that question affect the taxability of such income to taxpayers whose service and capital in 1955 created the income now

represented by the account receivable.[3] Taxpayers have enjoyed the economic gain represented by their right to receive income from the account receivable even though they did not receive payment of it from their obligor. The enjoyment of their economic gain was fully consummated when they made such use of their power to receive or control the income or to procure in its stead some other satisfaction which has economic value. The power to dispose of income is tantamount to ownership of it, and the exercise of that power in procuring payment to the partnership was the equivalent of the enjoyment of the income on the part of the taxpayers who exercised the right. *Helvering* v. *Horst*, *supra; Helvering* v. *Eubank*, *supra.* Thus, for income tax purposes the situation was the same as though their debtor had paid the sum in question to taxpayers and taxpayers had passed the sum on to the 1956 partnership. Although payment was made direct to the partnership the amount so paid represented gross income to taxpayers and is therefore taxable to them—not to the members of the alleged 1956 partnership.

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[3] Nowhere do taxpayers deny that it was their services and capital which created the account receivable during the year 1955.

II

Assuming Arguendo That a Valid Family Partnership Existed During the Year 1956, Then, for the Purpose of Allocating Partnership Income for That Year, the Land, Trees and Equipment Used by the Partnership Must Be Treated as if They Had been Contributed to the Partnership by Taxpayers

If the partnership for 1956 is recognized as being valid, then, the Government contends, as set out in detail in its opening brief, pp. 46-48, that the land, trees and equipment which comprised the Ramos Home Ranch must be treated as if they had been contributed to the partnership by taxpayers for the purpose of allocating the partnership income for that year among the partners. To treat the land, trees and equipment as having been rented to the partnership, as did the District Court (I-R. 69), is not supported by the evidence. The record evidence shows that no arrangements were made by the 1956 partnership to pay taxpayers any rent for the use of these assets. To treat the assets, for the purpose of allocating partnership income, as if they had been contributed to the partnership is, however, supported by the fact that the economic effect of allowing the partnership the use of the assets without requiring any compensation therefor is the same as if they had been contributed to the partnership.[4]

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[4] It is to be noted that in preparing the partnership federal income tax return for 1956 taxpayers' accountant, George Franzman, took a deduction for depreciation on the equipment used in the operation of the Ramos Home Ranch. (II-R. 490-491.)

By allocating to taxpayers an amount which it felt was a reasonable rental allowance for the use of the ranch's operating assets, the District Court has held that a reasonable rental allowance is a proper substitute, to protect against improper income-shifting within a family group by use of a family partnership, for the protection which Congress devised in Section 704(e)(2) of requiring the allocation of income based upon the capital contribution of each of the partners. Moreover, there is no factual basis on which to support the court's finding that 25 percent of the crop receipts was a reasonable rental. The only mention of this percentage as "rent" appears in the rental agreement which was to be for a period subsequent to the 1956 crop year and there is no indication that the rental agreement for that period was arrived at as the result of arm's-length bargaining. Thus, the Government submits that the lower court's holding that only 25 percent of the partnership's crop receipts should be credited to taxpayers for the use of the land, trees and equipment is erroneous.

Taxpayers' argument (Br. 46-48) that no part of the 1956 partnership income should be allocated to taxpayers for the use by the partnership of the land, trees and equipment comprising the Ramos Home Ranch, is, as has already been fully discussed in the Government's opening brief, without any merit whatsoever. For, as stated in the Government's opening brief, pp. 22-25, 44, Congress attempted by Sec. 340 of the Revenue Act of 1951, c. 521, 65 Stat. 452 (adding Section 191 and amending Section 3797 of the Internal Revenue Code of 1939), to bring the taxation

of "family partnerships" into line with the fundamental principles generally applied in taxing income from property and services. However, because of the possibility of distorting income by a literal application of the objective test there established, Congress also imposed certain limitations on the recognition of otherwise valid partnership agreements insofar as allocation of income was concerned. As stated in H. Rep. No. 82nd Cong., 1st Sess. pp. 33-34 (1951-2 Cum. Bull. 357, 381):

> Since legislation is now necessary to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer, it is considered appropriate at the same time to provide specific safeguards—whether or not such safeguards may be inherent in the general rule—against the use of the partnership device to accomplish the deflection of income from the real owner.
>
> Therefor the bill provides that in the case of any partnership interest created by gift the allocation of income according to the terms of the partnership agreement shall be controlling for income tax purposes except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital. In such cases a reasonable allowance will be made for the services rendered by the partners, and the balance of the income

will be allocated according to the amount of capital which the several partners have invested.

These same limitations are now contained in Section 704(e)(2) of the 1954 Code (Appendix A to the opening brief for the Government) which provides that the distributive share of a member of a family partnership whose interest was acquired by gift or purchase from another family member shall be determined by the partnership agreement "except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital." See also Treasury Regulations on Income Tax (1954 Code), Section 1.704-1 (e)(3) (Appendix A to the opening brief for the Government). Thus, to adopt the argument of taxpayers would be contrary to the limitations imposed by Section 704 on the determination of the distributive shares of the members of a family partnership and the Government urges this Court to reject such an argument.[5]

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[5] If, however, this Court should disagree with our contention that the assets in question should be treated as a capital contribution by taxpayers within the meaning of Section 704(e)(2) of the Code, then we submit that it would be appropriate to remand the case for determination of a reasonable rental, since the partnership unquestionably had the use of the assets and the arbitrary allowance made by the District Court does not adequately reflect the value of such use.

218 F. 2d 380, 383 (C.A. 9th)), have been forced to rely on what appears to be a fabrication in order to attempt to show that their children contributed capital to the partnership. Accordingly, taxpayers state (Br. 36-37):

> The daughter and son having each acquired a 25% interest in and to the "crops business" contributed that 25% interest to the partnership; the "crops business" consisting of the right to use and control of the trees, lands, and equipment, together with all accounts receivable of the said business and each of the children then contributed their said 25% interest in and to the rights of use, control, possession and enjoyment of the said lands, trees and equipment and the 25% interest each in and to the accounts receivable of the business during the 1956 partnership.

Nowhere do taxpayers point to any evidence to sustain their strained argument. Rather, that testimony which taxpayers rely on in an earlier part of their brief (Br. 15-16) clearly shows that taxpayers' children merely received an anticipatory assignment of income from their parents' farming operation. For, on cross-examination, taxpayers' daughter testified as follows (II-R. 301-302):

> Q. What was your interest? You didn't own land, did you, Mrs. Donaldson, or any interest in the land?
>
> A. No, we don't own the land.

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her part time bookkeeping duties and was paid therefor (II-R. 188, 287).

Q. You don't own any interest in the machinery?

A. No.

Q. There was no cash capital put into the partnership in '56?

A. No.

Q. Well, what was your twenty-five per cent interest in 1956?

A. In the partnership agreement. When we formed it we were going to be partners, were going to be a family partnership, all together, and whatever income we made we would share.

If we had losses, we would share them and we would pay our expenses, and whatever was left we would share twenty-five per cent, my father, my mother, my brother and I. I don't think you have to own land to have a share in anything.

Q. In other words, you feel you can participate in the profits from the land without owning any portion of the land?

A. Yes.

Q. And this is the type of partnership interest that you had, just in the profits generated by the assets?

A. Profits or losses that would be produced by the almond trees on the land.

Thus, the daughter's statement reveals that the children received no interest whatsoever in the assets of the farming operation. Concomitantly, they were thus unable to contribute to the partnership that which they themselves did not have. Taxpayers having retained complete interest in the operating assets of their ranch (I-R. 63), the income generated there-

from is taxable to them.[8] *Kuney* v. *Frank*, 308 F. 2d 719 (C.A. 9th); *Sellers* v. *Commissioner*, *supra*.

Respectfully submitted,

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[8] See the statement of George Franzman, taxpayers account, that all the income of the partnership was earned through the land and the trees thereon. (II-R. 533.)

Certificate

I certify that, in connection with the preparation of these briefs, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing briefs are in full compliance with those rules.

Dated: .... day of November, 1967.

STEPHEN H. PALEY
Attorney

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